CHAPTER 18

INTERNATIONAL ISSUES

The Treasury Department proposals would retain the basic scheme for taxing foreign-source income, but would address certain anomalies. A per-country limitation on the foreign tax credit would be instituted to remove the current incentive for corporations with excess foreign tax credits to invest in low-tax foreign jurisdictions. Sourcing rules used in computing the credit and in taxing non-resident aliens and foreign corporations would also be improved. The taxation of income earned by foreign corporations through U.S. branches would be rationalized to bring it more into line with the taxation of income earned through U.S. subsidiaries. Finally, the uncertainty relating to the proper treatment of foreign exchange gain and loss under current law would be resolved with respect to hedged transactions by treating such gain or loss as adjustments to interest.

REFORM FOREIGN TAX CREDIT

General Explanation

Chapter 18.01

Current Law

To avoid international double taxation of income, the United States allows U.S. taxpayers to credit foreign income taxes paid. The amount of credit which may be claimed is limited to the U.S. tax on foreign source income; this limit is measured as the portion of total U.S. tax, before credit, corresponding to the portion that foreign taxable income is of worldwide taxable income. The limitation is calculated on an "overall" basis; that is, the amount of potential credit is the aggregate of income taxes paid to all foreign countries, and foreign source taxable income is the aggregate of taxable income from all foreign countries. In effect, each taxpayer is allowed to average foreign effective tax rates above and below the U.S. rate; only if the average exceeds the U.S. rate are any potential credits denied.

All taxpayers are allowed to credit foreign income taxes that they pay directly. In addition, U.S. multinational corporations are allowed to credit a share of taxes paid by their foreign subsidiary corporations; this feature is called the "deemed paid" or "indirect" foreign tax credit. The share of taxes eligible for credit is related to the share of income repatriated to the U.S. parents. These taxes are subject to the limitation described above.

Reasons for Change

The objective of the foreign tax credit is to avoid double taxation of foreign income. The limitation is intended to prevent abuse by preserving the U.S. tax on domestic income. Assume, for example, that a U.S. taxpayer has $100 of U.S. income and $100 worth of income from country X, and that tax rates are 46 percent in the United States and 60 percent in X. Worldwide taxable income is thus $200 and U.S. tax before credit is $92. An unlimited foreign tax credit would yield only $32 of U.S. tax ($92-$60=$32). Even though a full $100 was earned in the United States, less than $46 in U.S. tax would be paid. In effect, the United States would be refunding the excess $14 of foreign tax paid on foreign income. With a properly designed limitation, the foreign tax credit claimed may not exceed $46, the U.S. tax on the foreign income. The limitation would prevent the credit from reducing U.S. tax on domestic income.

Limiting the credit to the U.S. tax on foreign income country by country, rather than on an overall basis, would be more consistent with this goal and would lead to more rational incentives for investment. Computing the limitation on an overall basis gives many taxpayers a tax-motivated incentive to invest abroad rather than in the United States. To continue the example from the preceding paragraph, note that the U.S. taxpayer investing in X and facing an overall limitation can lower his tax by shifting his investment from the United States to a foreign country with a low tax rate. For example, if he could earn $100 in a country Y, which has no income tax, he would be able to credit the full $60 paid to X, and his net U.S. tax would be only $32. Therefore, the U.S. tax system gives this taxpayer a $14 subsidy to earn $100 in Y rather than at home. The taxpayer is able to reduce his U.S. tax because the overall limitation allows the high tax in X to be averaged with the low tax in Y. Just as excess credits in X should not be allowed to offset U.S. tax on domestic income, the excess credits should not be made available merely because the taxpayer shifts domestic income to Y, a low tax foreign country.

In sum, the overall limitation leads U.S. multinational companies to distort their worldwide investment decisions for purely tax motivated reasons. The overall limitation is also inequitable. Two U.S. taxpayers investing in the same country may face different incentives and pay different net U.S. tax on their investments there, depending on unrelated activities.

Present methods for calculating deemed paid credits also have certain effects which should be corrected. Specifically, measurement of earnings and profits is not done consistently in all instances, the timing of distributions causes opportunities for tax avoidance and unintended tax penalties, and the rules concerning transactions in foreign currencies bias investment incentives in certain cases.

Proposal

The amount of income tax paid to a foreign country which may be claimed as a foreign tax credit in any year would be limited to the U.S. tax on income from that country. The limitation with respect to each country would be a fraction of the total pre-credit U.S. tax, equal to the ratio of taxable income from that country to worldwide taxable income.

The separate "baskets" of income (certain interest, DISC/FSC, and other) defined under current law would be retained and a limitation calculated for each basket within each foreign country. The separate limitation provisions of current law relating to oil and gas extraction income would also be retained and would operate on a country by country basis.

For purposes of these limitations, foreign taxes would be matched as closely as possible with the income to which they relate. Foreign subsidiaries that earn income in countries other than the one in which they are incorporated require special consideration. To prevent taxpayers in such situations from circumventing the per country limitation by mixing highly and lightly taxed foreign income, the proposal will require taxpayers to identify the countries of origin of the income repatriated by the subsidiaries, as well as the countries to which the taxes are paid.

This approach could have harsh results in the case where a foreign subsidiary incorporated in a country that taxes worldwide income has to pay tax (net of foreign tax credit) to this country on income earned elsewhere. The tax would be attributed to the country of incorporation but the income would not. In principle, this situation should be remedied by reassigning the tax to the countries from which the income arises. In practice, such tracing can present difficulties. Therefore, the Treasury Department expects that this issue will be addressed, as necessary, on a bilateral basis through U.S. income tax treaties.

The proposal would allow losses to offset income earned in other countries, with provisions for "recapture" and "regeneration" when income is subsequently earned in the loss country or countries. In the year a loss occurs, it would be prorated against the income earned in all other countries, in proportion to each country's share in taxable income. The loss can have two effects in the year it is prorated. It can reduce U.S. tax liability, by reducing U.S. income and/or lightly taxed foreign income, and it can increase the amount of excess foreign tax credits, by reducing the limitations in high tax countries. When income is subsequently earned in the loss country, each of these effects will be counteracted; the reduction in U.S. liability will be recaptured and the lost credits will be regenerated. The purpose of these rules is to make the total (undiscounted) U.S. tax liability over a period of several years depend only on total income and taxes in each country over the period, and not on the geographic pattern of income and losses in particular years.

Certain changes in the deemed paid credit would be made to ensure consistent measurement of earnings and profits, to prevent manipulation and penalties resulting from the timing of distributions, and to deal with foreign currency translation issues.

Consideration will also be given to indexing certain accumulations and items of foreign source taxable income for inflation. The methods would be as consistent as possible with the methods developed for indexing domestic source concepts. However, alterations may be necessary due to the administrative complexities and other concerns added by the international context in which these rules must operate.

Effective Date

The proposal would be effective, in general, for taxable years beginning on or after January 1, 1986. A five year carryforward of current excess foreign tax credits into the new system would be allowed; taxpayers may choose the country or countries to which they will apply. This rule helps ease the transition to the per country limitation in a natural way. Due to the substantial reduction in U.S. tax rates, however, excess credits generated under the reformed system will not be comparable to pre-reform quantities; therefore, carryback from post to pre-reform years will not be allowed. With these exceptions, the proposal would allow three years of carrybacks and five years of carryforwards on a per country basis.

Pre-reform overall foreign losses that have not been recaptured will require another set of transition rules. Each year, until these pre-reform losses are exhausted, taxpayers will determine the amount that they would have been required to recapture under current rules. This amount of foreign income will then be recharacterized as U.S. source; the taxpayers will be allowed to specify the countries from which this income is to be taken.

Analysis

A per country limitation to the foreign tax credit would eliminate double taxation of foreign income in a way that is in accord with U.S. tax treaties, without distorting the choice between domestic and foreign investment. A U.S. taxpayer deciding between investing in the United States or a foreign country would be less motivated by tax considerations to undertake the less profitable project. In contrast, with the overall limitation, a taxpayer with activities in a high tax foreign country pays less U.S. tax by making an investment in a low tax foreign country than by making an investment in the United States. The averaging of high and low foreign taxes allowed by the overall limitation results in investments being made which would not be profitable but for the tax savings. The proposed reduction in the U.S. corporate tax rate would increase excess foreign tax credits and, accordingly, would increase the incentive to divert investment and income to low-tax countries if the overall limitation were left in place. Adopting a per country limitation, together with the proposed changes in certain source rules, would preserve the U.S. tax on domestic income while avoiding double taxation of foreign income.

Adoption of a per country limitation is consistent with international practice. Most countries which avoid international double taxation by allowing a foreign tax credit use a per country limitation; and a per country limitation was used in the United States for many years (1932-1976), either alone or in combination with the overall limitation.

The proposed changes in the deemed paid credit would also remove biases in investment decisions and treat similar taxpayers more equally.

It is difficult to measure the extent to which investment patterns might be changed by the proposal, but the direction would be toward greater efficiency and equity.

MODIFY SOURCING RULES FOR INCOME AND DEDUCTIONS

General Explanation

Chapter 18.02

Current Law

Rules for defining the source of particular items of income serve two principal purposes. First, those rules define the scope of U.S. taxation of non-resident aliens and foreign corporations, particularly those that do not engage in a U.S. trade or business. Second, through the operation of the foreign tax credit mechanism, the source of income rules define the circumstances under which the United States is willing to concede primary jurisdiction to a foreign country to tax U.S. citizens and residents on income earned by them in that foreign country. In the respects relevant to the proposals set forth below, existing rules for determining the source of income and the allocation and apportionment of related expenses are as follows:

(a) **Income Derived from Purchase and Resale of Property.** Income derived from the purchase and resale of personal property, both tangible and intangible, is sourced at the location where the sale occurs. The place of sale is generally deemed to be the place where title to the property passes to the purchaser.

(b) **Income Derived from Manufacture and Sale of Property.** Income derived from the manufacture of products in one country and their sale in a second country is treated as having a divided source. Generally, such income is allocated one-half on the basis of the place of manufacture and half on the basis of the place of sale (determined under the title passage test), although resort to an independent factory price for purposes of this allocation is permitted if such a price exists.

(c) **Income Derived from License of Intangible Property.** Royalty income derived from the license of intangible property is sourced by reference to the place where the licensed intangible property is used.

(d) **Dividend Income.** Dividend income is generally sourced at the place of incorporation of the payor. However, if a U.S. corporation earns more than 80 percent of its income from foreign sources, dividends paid by that corporation are treated as foreign source income.

(e) **Interest Income.** Interest income is generally sourced on the basis of the residence of the payor. Under one exception to this rule, interest income received from a U.S. corporation which earns more than 80 percent of its income from foreign sources is treated as foreign source income. Other exceptions to the interest source rules are designed to be tax exemptions for limited classes of income.

(f) Interest Expense. Interest expense incurred by a related group of corporations is required to be allocated between domestic and foreign source income in computing foreign source taxable income and the foreign tax credit limitation. Under existing law, this allocation is made on a separate company basis, rather than on a combined group basis. Thus, a company within the related group that incurs interest expense takes only its own operations into account in allocating the expense, rather than the operations of the entire related group.

Reasons for Change

The following basic principles should be applied in formulating rules for determining the source of income. First, appropriate source of income rules should allocate income to the place where the economic activity generating that income occurs. Income derived from the use of property or capital should be sourced where the property or capital is used. Second, the rules should be neutral in the sense that the United States would have no ground for objection if its source of income rules were applied by other countries. Unless there are sufficient reasons to the contrary, international norms for source of income determinations should be followed to the extent such norms exist. Third, the rules should not allow erosion of the legitimate U.S. tax base through taxpayer manipulation of the source rules or of the foreign tax credit limitation. Fourth, the rules should be clear and readily applied. Adoption of a per country foreign tax credit limitation would increase the need for such clarity by requiring sourcing of income to specific foreign countries rather than simply requiring allocation between domestic and all foreign sources.

Existing rules for determining source of income fail to meet these standards in the following respects:

(a) Sales Income. Under the existing title passage test, the source of income derived from the sale of goods bears no necessary relationship to the economic activity generating that income. Because the place of title passage may be arbitrarily determined by affected taxpayers, the existing rule permits artificial manipulation of the foreign tax credit limitation and the U.S. tax base. The possibility of such manipulation is particularly troublesome in connection with transactions between related taxpayers.

(b) Sales of Intangible Property. Income derived from the sale of intangible property is determined under a title passage test while income derived from the license of such property is determined by reference to the place where the property is used. Often the economic distinction between a sale and a license of intangible property is elusive. Clarity and uniformity of treatment would be served by applying the same source of income rules to all transactions involving intangible property.

(c) **Dividend Income.** The existing source rule applicable to dividend income focuses on the domicile of the corporation distributing the dividend income. This rule, or a close variant of it focusing on the corporation's place of management, is followed in the tax systems of most countries. The rule is clear and easily applied and otherwise satisfies the characteristics of appropriate source rules.

The exception to this general rule for so-called 80-20 companies is much more questionable. It alters a sound, well accepted rule under circumstances where most foreign countries do not assert a competing source based claim to tax the income. This can result in total tax exemption of the dividend both in the United States and the relevant foreign country, and can facilitate tax haven opportunities for taxpayers.

(d) **Interest Income.** Just as with dividends, the 80-20 exception to the general source rule applicable to interest income alters an accepted rule in the absence of competing source based claims of foreign countries. Accordingly, the 80-20 company rule gives rise to tax haven type opportunities for some taxpayers and to opportunities for manipulation of the foreign tax credit limitation.

(e) **Interest Expense.** The separate company method of allocation enables taxpayers to limit artificially the interest expense allocated to foreign source income by manipulating the corporate structure of the related group. This may result in an unwarranted increase in the amount of foreign tax credit available to a related group of corporations.

Proposal

(a) **Source Rules Relating to Sales Income.** In general, income derived from the purchase and resale of inventory-type goods would be sourced in the country of the taxpayer's residence. An exception to this general rule would be provided if the predominant portion of the selling activity generating the income is carried on through a fixed place of business located outside the taxpayer's country of residence. In such a case, the income would be sourced in the country where the fixed place of business is located. The place where title to the goods passes to the buyer, the place where purchasing activity is carried out and the place of ultimate destination of the goods all would be irrelevant for purposes of determining the source of sales income. It is believed that this rule would correlate the source of sales income more closely with the location of the underlying selling activity without necessitating in every case an administratively complex determination of where the relevant sales activity occurs.

Similar changes would also be made in the rules for determining the source of income derived from the manufacture and sale of products. The existing practice of sourcing one-half of such income on the basis of the place of manufacture would continue. The remaining one-half of the income would be attributed to sales activity and would be sourced on the basis of the rules described in the preceding paragraph. The title passage test would be abandoned. Accordingly, no portion of the income derived from the manufacture of products in the United States and the sale of such products abroad would be sourced in a foreign country unless the predominant selling activity giving rise to the sales is carried out through a fixed place of business in that foreign country. The option of applying an independent factory price in allocating divided source income would be retained, provided that the predominant portion of the relevant sales activity is conducted through a fixed place of business outside the country of manufacture.

Income derived from sales of personal property used by the taxpayer in its business would be sourced in the place where the property is used. Income derived from the sale of personal property not described above, including in particular passive investment property, would be sourced at the place of the taxpayer's residence.

(b) Income Derived from Sales of Intangible Property. The rules relating to royalty income derived from licenses of intangible property would be retained in their present form. Source rules relating to sales of intangible property would be modified to correspond generally to the rules relating to licenses. Accordingly, intangible property related sales income generally would be sourced on the basis of where the underlying property is to be used. Consideration will be given to whether exceptions should be made to this rule for sales of certain types of intangible property.

(c) 80-20 Corporation Rules Relating to Interest and Dividends. The 80-20 corporation exceptions to the general source rules applicable to dividend and interest income would be repealed. Thus, dividend income would be sourced on the basis of the place of incorporation of the corporation paying the dividend. Interest income received from all U.S. residents and domestic corporations would be sourced on the basis of the residence of the payor without looking to the underlying source of the payor's income. Provisions of the existing source rules relating to interest income that are designed to provide tax exemptions for particular activities would not be repealed but would be restructured as overt exemption provisions in the interest of establishing neutral source rules.

(d) Allocation of Interest Expense. Interest expense would be required to be allocated to income from various sources on a combined group basis, rather than on a separate company basis.

Effective Date

The proposals would generally be effective for taxable years beginning on or after January 1, 1986. The modification of the source rule for interest income received from 80-20 corporations would be effective only with respect to interest paid on debt obligations incurred after the date of introduction of the legislation. Transitional rules would be provided for sales made under certain contracts executed prior to the date of introduction of the proposal as legislation.

Analysis

The proposals would create a set of rules for determining the source of income that is less subject to manipulation and more reflective of real underlying economic activity than the existing rules. The new rules would also be more suitable to the computation of the foreign tax credit limitation on a per country basis. It can be anticipated that under these proposals somewhat greater amounts of the income of U.S. taxpayers derived from sales of products to destinations located outside the United States would be treated in the future as domestic source income. As a result some foreign tax credits on income from U.S. economic activity may not be available. However, the United States should retain the primary taxing right over this income.

REPLACE SECOND DIVIDEND TAX WITH BRANCH PROFITS TAX

General Explanation

Chapter 18.03

Current Law

The effectively connected income of a U.S. branch of a foreign corporation is subject to U.S. income tax, but there is no additional tax, comparable to the withholding tax imposed on dividends paid by a U.S. subsidiary of a foreign corporation, on the branch's remittances to the home office. Instead, the tax code provides for the imposition of a U.S. withholding tax, known as the "second dividend tax", on a proportionate part of the dividends paid by the foreign corporation, if more than 50 percent of the corporation's gross income is effectively connected with a U.S. trade or business.

Reasons for Change

A U.S. corporation owned by nonresidents is subject to income tax on its profits, and, in addition, its foreign shareholders are subject to a tax on the dividends which they receive (30 percent by statute, reduced to as little as five percent by treaty). No comparable tax, beyond the corporate tax, is imposed on the distributed profits of a U.S. branch of a foreign corporation. The "second dividend tax" is intended as the analogue to the dividend withholding tax, but it fails to equalize the tax treatment of branches and subsidiaries in many cases. The "second dividend tax" applies only when a majority of the income of the foreign corporation is derived from its U.S. branches, while the dividend withholding tax applies to all distributions of subsidiary profits. Moreover, the enforcement of this tax is very difficult. It is difficult to know when the tax is due and difficult to enforce its collection by a foreign corporation.

Proposal

The "second dividend tax" would be repealed and replaced by an additional tax on the profits of U.S. branches of foreign corporations which would place the branch of a foreign corporation on a more comparable footing with a U.S. subsidiary of a foreign corporation.

All foreign corporations with a branch in the United States (a trade or business under the tax code or a permanent establishment under tax treaties) would be subject to the branch profits tax, unless it is prohibited by an existing U.S. tax treaty. The branch profits tax would not override existing treaties, but the Treasury Department would seek to amend those treaties which now prohibit the tax to permit its imposition. (Many treaties do not prohibit the imposition of such a tax.)

The tax base would be defined so as to approximate the distributed profits of a U.S. subsidiary. The taxable income of the branch as shown on its U.S. corporate tax return would be reduced by the U.S. corporate tax before foreign tax credits and by further adjustment to reflect reinvestment of profits in the branch. To adjust for such reinvestment, increases in net investment in the branch, for both fixed and working capital, would be deducted from the after corporate tax branch profits.

The rate of the branch tax would be the same as the dividend withholding tax rate, currently 30 percent. Where the foreign corporation is resident in a treaty country, the treaty rate applicable to direct investment dividends would apply.

The second withholding tax on interest raises further questions which need to be addressed. If it is decided to repeal that tax, adjustments to the branch profits tax must be considered.

Effective Date

The proposal would take effect for taxable years beginning on or after January 1, 1986.

Analysis

Under the proposal, U.S. tax would apply more evenly to foreign corporations doing business in the United States than under present law. Thus the tax rules would no longer influence a foreign investor's decision whether to operate in the United States through a branch or a subsidiary. (Under current law a branch operation is generally subject to lower U.S. taxes than a subsidiary, if the subsidiary pays dividends.) The branch profits tax is also more easily administrable and enforceable than the "second dividend tax." It can be handled on the regular income tax form of the branch.

There may be situations under bilateral income tax treaties with other countries where the availability of a dividends-paid deduction to a U.S. subsidiary of a company resident in the treaty country will result in heavier U.S. taxation of income earned through a U.S. branch of such company than through a subsidiary. In that event, consideration might be given to granting comparable corporate tax relief to branches of companies resident in the other country in the context of bilateral treaty negotiations.

The proposed change is not likely to have a significant effect on flows of capital into the United States. The latest available data indicate that most foreign corporations operating in the United States through branches are in the finance, insurance and real estate industries, with most of the income attributable to branch banks.

IMPOSE INTEREST TREATMENT ON FOREIGN EXCHANGE GAINS AND LOSSES

General Explanation

Chapter 18.04

Current Law

The Federal income tax consequences with respect to the treatment of foreign exchange rate fluctuations have been uncertain because there is little guidance with respect to such matters in the tax code and regulations, and precedents such as cases, revenue rulings and technical advice memoranda have taken different positions on the same issues.

Reasons for Change

The uncertainty of current law leads to abuse by taxpayers, and whipsawing of the Internal Revenue Service. Over the long run, actual foreign exchange gains and losses adjust for differences in interest rates across currencies. In the case of hedging transactions, the adjustment is almost perfect even in the short run. Making the tax treatment correspond to business and economic reality reduces opportunities for tax abuse and whipsawing.

Proposal

Foreign exchange gain or loss on a business-related foreign-currency-denominated asset that is hedged would be treated as an increase or decrease in the interest income from the asset. Similarly, foreign exchange gain or loss on a business-related foreign-currency-denominated liability would be treated as a decrease or increase in the interest expense on the liability. Gain or loss on the item, e.g., a forward contract, hedging the business-related foreign-currency-denominated asset or liability would also be treated as an adjustment in interest. As a result, foreign exchange gain would be sourced, and foreign exchange loss allocated and apportioned, in the same manner as interest. Although, as proposed, the change only would apply to hedged positions, further consideration will be given to extending these rules to all foreign currency-denominated assets and liabilities.

Effective Date

The modifications in the treatment of exchange gains and losses on business-related hedging transactions would be effective for transactions entered into after enactment. There would be no provisions for phase-in but there would be the opportunity for a taxpayer to elect grandfathering on hedging transactions that are open as of the date of enactment.

Analysis

Treating exchange gains and losses as adjustments in interest would eliminate the uncertainty of current law and correspond to business and economic reality. Gains and losses are treated as adjustments in interest in other areas of the tax code. Treating gains and losses on hedging transactions as an addition to or subtraction from interest may be easily integrated with the tax straddle provisions in the tax code. Moreover, the proposed changes would eliminate the potential for abuse by taxpayers. Since the potential for tax abuse is largely a function of the currency in which the transaction is denominated rather than the substance of the transaction, transactions would continue to correspond to business and economic reality. Thus, eliminating the potential would not have an appreciable direct effect on economic behavior.